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TAXATION: SOME GUIDELINES FOR STRUCTURING TRANSACTIONS

GARY G. BELKIN*

Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.¹

Inasmuch as taxpayers may plan their business transactions so as to minimize their federal tax liability, doing so often requires advice which reflects the most recent law on the subject. Thus, it is incumbent upon the tax practitioner to be familiar not only with the Internal Revenue Code,² but also with the most recent judicial pronouncements in this regard. The purpose of this article is to summarize the work of the United States Court of Appeals for the Seventh Circuit during the period June 1, 1979 to May 31, 1980 and to analyze some of the reported tax decisions³ in terms of their implications for structuring transactions.⁴

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1. *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). This quote from an opinion written by Judge Learned Hand is often cited to support the proposition that a taxpayer may, within the purview of the law, plan transactions so as to result in the least amount of tax. See, e.g., *Grove v. Commissioner*, 490 F.2d 241, 242 (2d Cir. 1973).

2. Hereinafter referred to as the Code.

3. *Home Mut. Ins. Co. v. Commissioner*, Nos. 79-1602, 79-1603 (7th Cir. April 29, 1980); *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980); *Ransburg Corp. & Subsidiaries v. Commissioner*, 621 F.2d 264 (7th Cir. 1980); *First Trust & Sav. Bank of Taylorville v. Commissioner*, 614 F.2d 1142 (7th Cir. 1980); *Hope School v. United States*, 612 F.2d 298 (7th Cir. 1980); *Carle Foundation v. United States*, 611 F.2d 1192 (7th Cir. 1979), *petition for cert. filed*, 49 U.S.L.W. 3120 (U.S. April 30, 1980) (No. 79-1721); *Sgro v. United States*, 609 F.2d 1259 (7th Cir. 1979); *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979); *Quarrie Charitable Fund v. Commissioner*, 603 F.2d 1274 (7th Cir. 1979).

4. To review the Seventh Circuit's handling of other issues, see *Holcomb v. United States*, 622 F.2d 937 (7th Cir. 1980) (involving civil penalty for failure to pay withholding taxes); *Challenger v. Local 1, Int'l Bridge, Structural, and Ornamental Ironworkers*, 619 F.2d 645 (7th Cir. 1980) (involving ERISA); *Johnson v. Commissioner*, 620 F.2d 153 (7th Cir. 1980) (involving improper interpretation of informal Internal Revenue Service publication); *Rohrbaugh v. Commissioner*, 611 F.2d 211 (7th Cir. 1979) (involving civil penalty for late filing of an estate tax return); *United States v. Balistrieri*, 606 F.2d 216 (7th Cir. 1979), *cert. denied*, 100 S. Ct. 1850 (1980) (involving procedure in criminal case); *Fremont v. McGraw-Edison Co.*, 606 F.2d 752 (7th Cir. 1979), *cert. denied*, 100 S. Ct. 1599 (1980) (involving ERISA); *United States v. Falk*, 605 F.2d 1005 (7th Cir. 1979), *cert. denied*, 100 S. Ct. 1079 (1980) (involving procedure in criminal case); *United States v. Sawyer*, 607 F.2d 1190 (7th Cir. 1979), *cert. denied*, 100 S. Ct. 1338 (1980) (involving procedure in criminal case); *United States v. Baron*, 602 F.2d 1248 (7th Cir. 1979), *cert. denied*, 444 U.S. 967 (1980) (involving procedure in criminal case); *LaSalle Nat'l Bank v. Rosewell*, 604 F.2d 530 (7th Cir. 1979), *cert. granted*, 100 S. Ct. 1310 (1980) (involving right to interest on refund

This article will first discuss two cases in which the court was called upon to determine whether alleged business purposes were sufficient to sustain transactions clearly motivated by tax avoidance.⁵ Second, a case involving the priority of a federal tax lien will be considered.⁶ Third, a decision regarding imputed interest on the installment sale of a patent will be examined.⁷ Fourth, two cases dealing with taxation of unrelated business income of tax-exempt organizations will be reviewed.⁸ Fifth, a decision concerning private foundation status of a charitable fund will be discussed.⁹ Finally, two cases involving application of the "tax benefit rule" will be reviewed.¹⁰

SUFFICIENCY OF BUSINESS PURPOSE

Although a taxpayer may plan transactions so as to minimize taxes, a transaction must have a purpose other than tax avoidance to be recognized for tax purposes.¹¹ Courts must often determine whether a transaction is supported by a valid purpose. Two cases¹² reported by the Seventh Circuit during the period June 1, 1979 to May 31, 1980 involved a determination of whether valid business purposes existed in transactions prompted by tax avoidance. In both instances the court found in favor of the taxpayer.¹³

of real estate taxes); *United States v. Carter*, 602 F.2d 799 (7th Cir. 1979), *cert. denied*, 444 U.S. 967 (1980) (involving procedure in criminal case); *United States v. McDonough*, 603 F.2d 19 (7th Cir. 1979) (involving criminal sanctions for making false withholding claims); *United States v. Moll*, 602 F.2d 134 (7th Cir. 1979) (involving application of attorney-client privilege to records of taxpayer's accountant held by his attorney and issuance of an Internal Revenue Service summons in a criminal case); *United States v. Stout*, 601 F.2d 325 (7th Cir. 1979), *cert. denied*, 444 U.S. 979 (1980) (involving criminal prosecution of a tax protestor); *Garsky v. United States*, 600 F.2d 86 (7th Cir. 1979) (involving civil penalty for failure to pay withholding taxes).

5. *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980); *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979). See text accompanying notes 11-66 *infra*.

6. *Sgro v. United States*, 609 F.2d 1259 (7th Cir. 1979). See text accompanying notes 67-82 *infra*.

7. *Ransburg Corp. & Subsidiaries v. Commissioner*, 621 F.2d 264 (7th Cir. 1980). See text accompanying notes 83-95 *infra*.

8. *Hope School v. United States*, 612 F.2d 298 (7th Cir. 1980); *Carle Foundation v. United States*, 611 F.2d 1192 (7th Cir. 1979), *petition for cert. filed*, 49 U.S.L.W. 3120 (U.S. April 30, 1980) (No. 79-1721). See text accompanying notes 96-123 *infra*.

9. *Quarrie Charitable Fund v. Commissioner*, 603 F.2d 1274 (7th Cir. 1979). See text accompanying notes 124-141 *infra*.

10. *First Trust & Sav. Bank of Taylorville v. Commissioner*, 614 F.2d 1142 (7th Cir. 1980); *Home Mut. Ins. Co. v. Commissioner*, Nos. 79-1602, 79-1603 (7th Cir. April 29, 1980). See text accompanying notes 142-179 *infra*.

11. The leading case frequently cited for this requirement is *Gregory v. Helvering*, 293 U.S. 465 (1935).

12. *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980); *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979).

13. Although the taxpayers prevailed in *Foglesong* and *Falkoff*, both cases were remanded. In *Foglesong* the case was remanded to the Tax Court for determination of an issue not previously

Characterizing a Corporate Distribution as a Return of Capital

In *Falkoff v. Commissioner*,¹⁴ a case which at first blush presents a surprising result, the Seventh Circuit held that a \$10 million distribution from a corporation to a partnership, its sole shareholder, constituted a return of capital rather than a dividend.¹⁵ In reaching its decision, the Seventh Circuit appears to have given substantial weight to the premise that a taxpayer may plan transactions so as to result in the least amount of tax. Thus, although the Seventh Circuit acknowledged that the transaction was motivated by tax avoidance purposes, it noted that "[t]he taxpayer's purpose to avoid taxation alone does not provide a sufficient basis for reshaping the transaction to change its tax repercussions."¹⁶

Falkoff involved a rather complicated series of financial transactions. The corporation, which filed a consolidated income tax return with its subsidiaries, had no accrued earnings and profits as of September 30, 1969, the last day of its fiscal year.¹⁷ A wholly-owned subsidiary had negotiated but not finalized the sale of a parcel of real estate.¹⁸ If the sale had been completed by September 30, 1969, the sale would have generated earnings and profits so that a distribution to the partnership would have been taxed as a dividend.¹⁹

A plan was devised whereby the corporation would make a distribution to the partnership prior to September 30, 1969, in anticipation of the forthcoming sale of real estate. On September 29, the corporation borrowed \$18 million from the First National Bank of Chicago.²⁰ The corporation transferred \$17.5 million of the loan proceeds to the partnership, characterizing \$7.5 million as payment of an existing debt and the remaining \$10 million as a return of capital. The partnership used

examined by the Tax Court. 621 F.2d at 873. See text accompanying note 51 *infra*. *Falkoff* was remanded for determination as to the plaintiff's basis in the corporate stock it owned. This factual determination, however, did not go to the main issue of the case. 604 F.2d at 1052.

14. 604 F.2d 1045 (7th Cir. 1979).

15. *Id.* If the distribution had been characterized as a dividend, it would have been taxable to the shareholder as ordinary income. I.R.C. §§ 61(a)(7), 301(c)(1).

As a return of capital, the distribution reduces the shareholder's basis in the stock and, to the extent the distribution exceeds that basis, it is taxed as a capital gain from the sale of stock. I.R.C. §§ 301(c)(2)-(3)(A), 1221-1222.

16. 604 F.2d at 1048. *But see* note 23 *infra*.

17. *Id.* at 1046-47.

18. *Id.* at 1047. The property, located in Contra Costa County, California, was sold for \$12,250,000 and was reported as an \$11,002,410 long-term capital gain in the corporation's consolidated income tax return for the fiscal year ended September 30, 1970. 36 T.C.M. (CCH) 417, 418 (1977).

19. A distribution of property made by a corporation to its shareholders is a dividend to the extent of its current or accumulated earnings and profits. I.R.C. § 316(a).

20. Hereinafter referred to as the Bank.

\$15.5 million of the funds to repay the bulk of a debt obligation to the Bank. The real estate sale was completed by October 2, 1969, which was in the following fiscal year. After the sale was completed, the subsidiary transferred \$10 million to the corporation, which used the money to pay off part of its September 29 loan.²¹

The Commissioner contended that these events were merely steps in a single transaction,²² that the plan lacked substance²³ and that the distribution to the partnership constituted a constructive dividend²⁴ to the extent of the corporation's earnings and profits for the fiscal year ended September 30, 1970.²⁵ Although the Tax Court held in favor of the Commissioner,²⁶ it apparently disagreed with the step transaction approach. The court regarded the \$18 million loan to the corporation as equivalent to a nonrecourse loan to the partnership inasmuch as the partnership's stock in the corporation was pledged as collateral for the loan.²⁷ Relying upon *Gross v. Commissioner*,²⁸ the Tax Court acknowledged the right of a corporation to pay a dividend out of borrowed funds based upon appreciated assets. The court, however, regarded a distribution from funds supplied by the shareholders through a bank loan as an exception to the *Gross* rule. The distribution was considered as having neither a business purpose nor economic substance.²⁹

The Tax Court considered the repayment of the bank loan by the corporation in the following fiscal year as a payment of the partnership's debt. As such, the loan repayment was treated as a constructive payment to the partnership taxable to the extent of the corporation's earnings and profits for its fiscal year ended September 30, 1970.³⁰

21. 604 F.2d at 1047.

22. *Id.* Under the judicially established step transaction doctrine, where a series of separate transactions is considered as integrated parts of a single plan, for tax purposes they are treated as a single transaction. This will result in a different income tax treatment than if each step were treated independently of the others. For a general discussion of the step transaction doctrine see R. PAUL & P. ZIMET, STEP TRANSACTIONS, SELECTED STUDIES IN FEDERAL TAXATION (2d ser. 1938).

23. 604 F.2d at 1047. The Commissioner argued that there was no business purpose for the September 29 loan to the corporation. *Id.* A transaction must have some purpose other than tax avoidance if it is to be recognized for tax purposes. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

24. Although a formal dividend is not declared by a corporation, a distribution to a shareholder in his capacity as such may be treated as a dividend regardless of the form of the distribution. For a general discussion of constructive dividends see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.05 (4th ed. 1979).

25. 604 F.2d at 1047.

26. *Falkoff v. Commissioner*, 36 T.C.M. (CCH) 417 (1976).

27. *Id.* at 422.

28. 23 T.C. 756 (1955), *aff'd*, 236 F.2d 612 (2d Cir. 1956).

29. 36 T.C.M. (CCH) at 422.

30. *Id.* at 423.

The approach taken by the Seventh Circuit was to determine what it considered to be the "economic reality of the transaction."³¹ In rejecting the finding of the Tax Court, the Seventh Circuit concluded that the pledge of stock did not cause the Bank to look to the partnership for satisfaction of the debt obligation and that the loan had, in fact, been made to the corporation. The court stated that the stock only represented the underlying value of the corporation's assets and that adequate security could have been obtained through a mortgage of those assets. The value of the pledged collateral for the \$18 million loan was over \$30 million, of which approximately \$24 million was put up directly by the corporation.³² The Seventh Circuit also concluded that the transaction, which resulted in payment of a \$7.5 million debt and a \$10 million reduction in the net worth of the corporation, had economic substance.³³

The court went on to state that even if the loan were a sham, the Tax Court finding would be incorrect in that the transaction occurred in the fiscal year ended September 30, 1969, when the corporation had no earnings and profits.³⁴ The Seventh Circuit focused on the date the partnership paid its direct obligation to the Bank. It would seem, however, that if the September 29 Bank loan had in fact been for the benefit of the partnership, perhaps the relevant date should be the date of repayment of the September 29 loan.³⁵

Although the decision in *Falkoff* analyzed what the Seventh Circuit considered to be the "economic reality" of the transaction,³⁶ the decision does not reflect a complete analysis of the income tax ramifications. The Seventh Circuit stated that the only effect of the transaction was to delay the tax until such time as the shareholder might sell its stock in that the basis of the stock was reduced by the \$10 million return of capital.³⁷ What the court did not consider was that the gain on the disposition of the stock would be taxable as a long-term capital gain at more favorable rates than the dividend, which is taxable as ordinary income.³⁸ Furthermore, if the shareholder were to die owning the stock, the gain would never be taxed since the basis would be stepped

31. 604 F.2d at 1050.

32. *Id.* The taxpayer contended that pledging the partnership's stock to secure the corporate debt was a common commercial practice used to eliminate the need for mortgages and U.C.C. filings on the corporation's underlying assets.

33. *Id.*

34. *Id.* at 1050-51.

35. See text accompanying note 30 *supra*.

36. See text accompanying note 31 *supra*.

37. 604 F.2d at 1051.

38. I.R.C. §§ 1201, 1221-1223.

up to the date of death (or alternate valuation date) value.³⁹

The value of *Falkoff* as a guide in planning transactions is of course limited to situations where a corporation without earnings and profits can borrow money in anticipation of the sale of appreciated assets. If the loan is not adequately secured by the assets of the corporation,⁴⁰ a different result could very likely be reached by a court which seeks to determine the economic substance of a transaction.

Taxation of Personal Service Corporation Income

The decision in *Falkoff* was based upon a determination of the party for whose benefit a bank loan had been obtained. In another case involving tax avoidance motivation, *Foglesong v. Commissioner*,⁴¹ the Seventh Circuit decision was based upon a determination of which party had earned certain income.

The issue in *Foglesong* was whether income of a corporation derived from the personal services of its owner-employee should be taxed to the owner-employee rather than to the corporation.⁴² The taxpayer in *Foglesong*, a successful sales representative for two manufacturers of steel tubing, incorporated his business in 1966. Consequently, of one hundred shares of common stock outstanding, ninety-eight shares were held by the taxpayer and one each were held by his wife and his accountant. Preferred stock was issued to the taxpayer's minor children. Following incorporation, at the taxpayer's request, commission checks were made payable to the corporation.⁴³ Due to the effect of graduated income tax rates, by incorporating and splitting the income among several taxpayers the total amount of income tax payable would be reduced.

Three arguments are available to the Internal Revenue Service to sustain a position that personal service income should be taxed to an individual rather than to his corporation: (1) that the corporation is a sham; (2) that the owner-employee assigned the income to the corporation;⁴⁴ or (3) that an allocation is necessary under Code section 482.⁴⁵

39. I.R.C. § 1014. Carryover basis was repealed by the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 299 (1980).

40. See text accompanying note 32 *supra*.

41. 621 F.2d 865 (7th Cir. 1980).

42. *Id.* at 865.

43. *Id.* at 866.

44. See note 48 *infra*.

45. 621 F.2d 866 (7th Cir. 1980). Discretion is granted to the Secretary to allocate income among commonly owned or controlled taxpayers "in order to prevent evasion of taxes or clearly reflect . . . income" I.R.C. § 482.

Although the Tax Court in *Foglesong*⁴⁶ recognized the corporation as a viable taxable entity,⁴⁷ it concluded that the taxpayer's prime motivation in incorporating was avoidance of taxes and that his control over earning the income was sufficient to consider the income to be taxable to him under the assignment of income theory of *Lucas v. Earl*.⁴⁸ In reaching this conclusion, the Tax Court considered the assignment of income doctrine and the right of a taxpayer to arrange business affairs so as to minimize taxes as inherently conflicting principles.⁴⁹

The Seventh Circuit, with one judge dissenting, reversed the Tax Court on the assignment of income theory.⁵⁰ Nevertheless, the case was remanded to the Tax Court for a determination of the section 482 issue.⁵¹

In reversing the Tax Court on the assignment of income issue, the Seventh Circuit stated that application of this doctrine would effectively nullify the determination that the corporation was a viable taxable entity.⁵² The Seventh Circuit emphasized the "policy of the law to recognize corporations as economic actors except in exceptional circumstances"⁵³ and stated that the business purposes for forming a corporation should not be weighed against tax avoidance motives "in order to question the validity of a transaction purportedly entered into by a corporation, rather than the validity of the corporation itself."⁵⁴

The Seventh Circuit distinguished the *Foglesong* case from *Lucas v. Earl*⁵⁵ where a taxpayer had assigned only his income.⁵⁶ The court concluded that, unlike *Lucas*, *Foglesong* involved a novation of the contracts with the manufacturers so that the corporation, and not the taxpayer, was responsible for the performance of sales services and entitled to the income from those contracts.⁵⁷ The Seventh Circuit analogized the *Foglesong* facts to those in *Fontaine Fox v. Commissioner*,⁵⁸

46. 35 T.C.M. (CCH) 1309 (1976).

47. *Id.* at 1312. The corporation adopted bylaws, elected directors, conducted directors' and shareholders' meetings and otherwise complied with all formalities required of corporations. 621 F.2d at 867.

48. 281 U.S. 111 (1930). Under this doctrine, a taxpayer who earns income is subject to tax on that income notwithstanding that he may have assigned the right to receive that income to somebody else.

49. 35 T.C.M. (CCH) 1309, 1312 (1976).

50. 621 F.2d at 873.

51. *Id.*

52. *Id.* at 869.

53. *Id.* at 872.

54. *Id.* at 869.

55. 281 U.S. 111 (1930).

56. 621 F.2d at 870.

57. *Id.*

58. 37 B.T.A. 271 (1938).

where a cartoonist transferred cartoon copyrights and service contracts to his corporation.⁵⁹

Foglesong is a significant case from the perspective of providing guidance for planning future transactions in that it sets forth guidelines for limitation of the assignment of income doctrine. For purposes of determining how to structure similar situations, it may be helpful to note that in concluding that the income in *Foglesong* was taxable to the corporation the Seventh Circuit looked to the following factors:⁶⁰

1. That the corporation was responsible for performance of the service contracts;
2. That the corporation was recognized as a viable, taxable entity;
3. That non-tax business purposes (obtaining limited liability and expanding the business) were present;
4. That the corporation was not formed to take advantage of losses of a separate business;
5. That the corporate form was recognized in business transactions;⁶¹
6. That the taxpayer rendered services only to the corporation;⁶²
7. That no law required the services to be performed by an individual rather than a corporation;⁶³
8. That the manufacturers which paid the income were not controlled or dominated by the taxpayer;⁶⁴
9. That other, more appropriate legal bases existed for attacking the transaction.

While the majority opinion in *Foglesong* presents a detailed analysis of the legal principles underlying the assignment of income doctrine, Justice Wood's dissenting opinion offers little analytical guidance. Justice Wood merely concluded that the tax avoidance motivation was great enough to require finding against the taxpayer either under the assignment of income reasoning of the Tax Court or as within the discretion of the Commissioner under section 482.⁶⁵

Although the majority opinion was limited to the assignment of income issue, if the case had been decided under section 482, the result

59. *Id.* at 272-73.

60. 621 F.2d at 868-69.

61. The court distinguished *Roubik v. Commissioner*, 53 T.C. 365 (1969), wherein four radiologists disregarded the corporate form in their business transactions. 621 F.2d at 871.

62. The court distinguished *American Savings Bank v. Commissioner*, 56 T.C. 828 (1971), where there was no formal employment relationship between the shareholders and the corporation. 621 F.2d at 871.

63. The court distinguished *Jones v. Commissioner*, 64 T.C. 1066 (1975), where federal law required court reporting services to be performed by an individual and not a corporation. 621 F.2d at 872.

64. The court distinguished *Rubin v. Commissioner*, 51 T.C. 251 (1968), *rev'd*, 429 F.2d 650 (2d Cir. 1970), where the owner-employee of a personal service corporation also controlled the company for which the services were to be performed. 621 F.2d at 870-71.

65. 621 F.2d at 873.

may very well have been different. The court, in rejecting the assignment of income approach, stated that "[h]ere there are other more precise devices for coping with the unacceptable tax avoidance which is unquestionably present in this case. But there is no need to crack walnuts with a sledge hammer."⁶⁶

If the Tax Court on remand applies section 482 to allocate income to the taxpayer, the tax benefits available through the use of personal service corporations could be sharply curtailed. An allocation of income to the shareholder-employee who performs the services would eliminate the tax savings achieved by splitting the income among several taxpayers. Even more significant would be the fact that if a corporation has no income, there can be no contribution to qualified retirement plans. Without such qualified retirement plans there may be little reason to incorporate a personal service business.⁶⁷

PRIORITY OF A FEDERAL TAX LIEN

Unlike *Falkoff* and *Foglesong*, tax avoidance was not an issue in *Sgro v. United States*,⁶⁸ wherein the Seventh Circuit decided that a federal tax lien had priority over a security agreement. The *Sgro* case illustrates the need for obtaining adequate security where a note is received in payment for shares of a closely held corporation.

The taxpayer, the sole shareholder of a corporation, sold all his stock in the corporation for cash and a note signed by both the purchasers and the corporation. The note was secured by the assets of the corporation, including accounts receivable. The taxpayer perfected his lien by filing a financing statement in accordance with state requirements. Thereafter, the Internal Revenue Service assessed a deficiency against the corporation for unpaid employment and withholding taxes and filed a notice of a tax lien. To satisfy part of the deficiency, the Internal Revenue Service levied upon accounts receivable of the corporation and seized cash in the corporation's safe and cash register. The taxpayer brought suit to recover these amounts after the purchasers defaulted on their note.⁶⁹

The sole issue in *Sgro* was whether the security agreement granted to the taxpayer to secure payment of the note was a "commercial tran-

66. *Id.* at 872.

67. For a further analysis of the effect of *Foglesong* on personal service corporations, see Burdett, *Foglesong's Sec. 482 Approach May Threaten Closely-Held Personal Service Corporations*, 53 J. TAX. 330 (1980).

68. 609 F.2d 1259 (7th Cir. 1979).

69. *Id.* at 1262-63.

sactions financing agreement" as defined in the Code.⁷⁰ If the security agreement had met the definition, the taxpayer's lien would have had priority over the federal tax lien.⁷¹

In reversing the district court,⁷² the Seventh Circuit concluded that the statutory definition was not satisfied for two reasons. First, a commercial transactions financing agreement must be "entered into by a person in the course of his trade or business."⁷³ With regard to this point, the Seventh Circuit noted that sale of stock is an investment activity which is not a trade or business.⁷⁴ Second, the loan must be made to a taxpayer "to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business."⁷⁵ Inasmuch as the loan was made to the purchasers of the stock, and not to the corporation, the court concluded that it was not made to the "taxpayer" as required by the statute.⁷⁶

The Seventh Circuit, which reached its decision by a technical analysis of the statutory language, also noted that the congressional purpose in enacting the "commercial transactions financing agreement" rule was to protect creditors who rely upon inventory or accounts receivable to secure their loans from recently filed tax liens.⁷⁷ The court stated that:

Because subsection (c)(2) advocates the general rule of first in time, first in right, Congress narrowly defined its applicability to a specific problem posed by the exigencies of Commerce. It chose not to extend protection to those whose engagement in the enumerated trans-

70. See I.R.C. § 6323(c)(2)(A), which defines a "commercial transactions financing agreement" as follows:

(A) Definition.—The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)—

(i) to make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the course of his trade or business, or

(ii) to purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business; but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser had actual notice or knowledge of such tax lien filing.

71. I.R.C. § 6323(c)(1)(A)(i) provides that a federal tax lien is not valid as against a security interest arising after the filing of the federal tax lien if that security interest is pursuant to a "commercial transactions financing agreement" entered into prior to the filing of the federal tax lien.

A lien on accounts receivable arising after the filing of a lien remains inchoate until the debt becomes due. Therefore, the taxpayer's financing statement would have to qualify as a "commercial transactions financing agreement" to have priority over the federal tax lien for accounts receivable becoming due after the tax lien filing.

72. *Sgro v. United States*, No. 76-0057 (S.D. Ill. Dec. 19, 1978).

73. I.R.C. § 6323(c)(2)(A).

74. 609 F.2d at 1264.

75. I.R.C. § 6323(c)(2)(A)(i).

76. 609 F.2d at 1264.

77. *Id.* at 1265.

actions is not incident to their "trade or business" and to those who extend loans to debtors other than the taxpayer.⁷⁸

The court went on to conclude that the *Sgro* transaction was not of the type intended to be protected.⁷⁹

Prior to the enactment of the Federal Tax Lien Act of 1966,⁸⁰ a federal tax lien had priority over all inchoate rights of others.⁸¹ Section 6323 of the Code now provides protection for those who take back a security interest including inchoate interests under certain conditions.⁸² As the decision in *Sgro* illustrates, however, a federal tax lien still has priority over the inchoate rights of others where these conditions are not satisfied. The Seventh Circuit will interpret strictly the legislative language.

Thus, *Sgro* evidences the need for careful planning to have priority over a federal tax lien. In structuring the sale of shares of a closely held corporation, the choate interests should be adequate to secure a note given by the purchasers in payment for the shares where that note is secured by assets of the corporation.

IMPUTED INTEREST ON SALE OF A PATENT

The Seventh Circuit also employed a strict interpretation of Code language in deciding *Ransburg Corp. & Subsidiaries v. Commissioner*.⁸³ In that case, it affirmed a Tax Court decision that a portion of deferred payments received by a corporation from the sale of patents constituted interest.⁸⁴

The taxpayer, a corporation, sold certain patents to a Japanese corporation in which it had a forty-nine per cent interest and received payment therefor in installments over a period of several years.⁸⁵ The sales contract made no provision for interest on the deferred payments and the entire gain was reported by the taxpayer as long-term capital gain.⁸⁶

78. *Id.*

79. *Id.*

80. I.R.C. §§ 6321-6326.

81. See W. PLUMB, FEDERAL TAX LIENS (3d ed. 1972).

82. *E.g.*, a commercial transactions financing agreement protects only security interests which arise within 45 days after the federal tax lien is filed. I.R.C. § 6323(c)(2)(B). Therefore, an accounts receivable financier should check for the existence of a federal tax lien once every 45 days in order to be protected.

83. 621 F.2d 264 (7th Cir. 1980).

84. *Ransburg Corp. & Subsidiaries v. Commissioner*, 72 T.C. 271 (1979).

85. The taxpayer received a total of \$5,178,677 during the years 1963 through 1972. 72 T.C. at 274.

86. 621 F.2d at 265.

Generally, a portion of deferred payments received from the sale or exchange of property where some or all of the payments are due more than one year following the sale or exchange will be deemed to be interest where interest is not otherwise provided for.⁸⁷ The Commissioner, therefore, contended that a portion of the payments received by the taxpayer in *Ransburg* constituted interest.⁸⁸ In agreeing with the Commissioner, the Seventh Circuit concluded that an exception to the general rule, which provides that no interest is imputed on payments received "pursuant to a transfer described in Section 1235(a),"⁸⁹ was inapplicable to the facts presented in *Ransburg*.⁹⁰

The Seventh Circuit's decision is based upon a precise application of statutory language. Code section 1235(a) provides for long-term capital gain or loss treatment on the transfer of a patent "by any holder."⁹¹ Inasmuch as a "holder" is defined in Code section 1235(b) as excluding a corporation,⁹² the sale was not covered by section 1235(a) and the exception could not apply.

Although the gain in *Ransburg* did not qualify as a long-term capital gain under section 1235(a), it was, nonetheless, taxable as a long-term capital gain in that the patent was found to be a capital asset.⁹³ The taxpayer had argued that the congressional intent was for the exception to apply to all sales of patents which resulted in capital gain, and that the section 483(f)(4) reference to "transfers described in Section 1235(a) . . ." did not require the definition in section 1235(b) to be met.⁹⁴ The Seventh Circuit, however, concluded that this position was not supported by the legislative history.⁹⁵

It is possible that Congress overlooked the application of Code section 483(f)(4) to other capital gains from the sale of patents. Nonetheless, where courts strictly interpret Code language, it appears that a legislative amendment may be necessary to broaden its application. Thus, for purposes of planning future transactions it should be noted that, absent congressional action, interest probably will be imputed on installment payments received by a corporation in payment for patents which qualify as capital assets.

87. I.R.C. § 483.

88. 621 F.2d at 265-66.

89. I.R.C. § 483(f)(4).

90. 621 F.2d at 267.

91. I.R.C. § 1235(a).

92. See I.R.C. § 1235(b).

93. 621 F.2d at 265.

94. *Id.* at 266.

95. *Id.* at 268.

TAX ON UNRELATED BUSINESS TAXABLE INCOME

Two cases decided by the Seventh Circuit between June 1, 1979 and May 31, 1980, *Carle Foundation v. United States*⁹⁶ and *Hope School v. United States*,⁹⁷ dealt with the question of whether an activity of an otherwise tax-exempt organization⁹⁸ generated "unrelated business taxable income."⁹⁹ This question is important because unrelated business taxable income is subject to income tax calculated in the same manner as the tax on corporations.¹⁰⁰

Unrelated business taxable income is defined, with certain exceptions, as "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it"¹⁰¹ Although both cases required a determination of whether the activity in question generated "unrelated business taxable income," each case involved the interpretation of a different section of the Code.¹⁰² Since a major purpose in enacting the tax on unrelated business taxable income was to preclude tax-exempt organizations from having a competitive advantage over taxable entities which engage in similar activities,¹⁰³ in each case the Seventh Circuit considered as relevant whether the activity caused the organization to have such a competitive advantage.

Carle Foundation involved a foundation complex whose facilities were composed of a hospital and a pharmacy. Office space within the complex was rented to a private medical clinic run by doctors engaged

96. 611 F.2d 1192 (7th Cir. 1979).

97. 612 F.2d 298 (7th Cir. 1980).

98. See I.R.C. § 501. Certain types of entities enumerated in section 501 are exempt from federal income taxes. The two cases reported by the Seventh Circuit involved entities which come within the following classification of tax-exempt organization:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office. I.R.C. § 501(c)(3).

99. See text accompanying note 101 *infra*.

100. See I.R.C. § 511.

101. I.R.C. § 512(a).

102. *Carle* dealt with the relation of the activity to the tax-exempt purpose of the organization, I.R.C. § 513(a), whereas *Hope* dealt with whether the proceeds were the product of a regularly conducted trade or business, I.R.C. §§ 511, 512.

103. See Treas. Reg. § 1.513-1(b) (1980), which states in part, "[t]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete."

in the practice of medicine for profit. Unlike the Carle Foundation,¹⁰⁴ the clinic was not a tax-exempt organization.

Although the Foundation facilities and the clinic were separate legal entities, they shared many of the same services and facilities. The Foundation hospital was staffed almost entirely by doctors from the clinic, although those doctors were not employees of the hospital. In addition, clinic patients requiring hospitalization generally were admitted to the Foundation hospital. Furthermore, the pharmacy supplied pharmaceuticals to the hospital as well as to the clinic and to some of the clinic's patients.¹⁰⁵

The Internal Revenue Service contended that income from pharmaceutical sales to the clinic and its private patients constituted taxable income from a trade or business unrelated to the tax-exempt purposes of the Foundation.¹⁰⁶ The Seventh Circuit, agreeing with the government, reversed a contrary finding by the district court.¹⁰⁷

In reaching its decision, the Seventh Circuit methodically analyzed the statutory requirements to determine whether the sales generated income from a regularly operated business unrelated to the Foundation's tax-exempt purpose. The Code, in pertinent part, defines "unrelated trade or business" as:

[A]ny trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its . . . purpose or function constituting the basis for its exemption under section 501 . . . except that such term does not include any trade or business—which is carried on, in the case of an organization described in section 501(c)(3) . . . by the organization primarily for the convenience of its . . . patients¹⁰⁸

After deciding that prescription sales to the clinic and the clinic's private patients were not primarily for the convenience of the Foundation's patients,¹⁰⁹ the Seventh Circuit concluded that the sales were not substantially related to the tax-exempt purposes of the Foundation as set forth in an affidavit to the Internal Revenue Service at the time it applied for tax-exempt status.¹¹⁰ This conclusion was based upon a finding that the sales were in direct competition with non-exempt phar-

104. Hereinafter referred to as the Foundation.

105. 611 F.2d at 1193-94.

106. *Id.* at 1194.

107. *Carle Foundation v. United States*, No. 75-2-148 (E.D. Ill. Mar. 30, 1978).

108. I.R.C. § 513(a).

109. 611 F.2d at 1194-96. The determination was based upon an analysis of Rev. Rul. 68-376, 1968-2 C.B. 246, which contains examples of who is considered a patient within the meaning of Code section 513(a)(2).

110. 611 F.2d at 1196.

macies.¹¹¹

The Seventh Circuit considered the situation in *Carle Foundation* to be similar to that in Revenue Ruling 68-375,¹¹² wherein a hospital operated a pharmacy in an adjacent medical office building which it owned and leased to some members of its medical staff. The Internal Revenue Service ruled that the pharmacy, which was operated primarily for the convenience of patients of doctors in the medical office building, constituted an unrelated trade or business. The court noted that in both situations, Revenue Ruling 68-375 and *Carle Foundation*, pharmaceuticals were sold in connection with the purchaser visiting his private physician rather than the use of hospital facilities.¹¹³

The same panel which decided *Carle Foundation* in favor of the government on November 29, 1979, decided *Hope School* against the government on January 2, 1980, reversing the decision of the district court.¹¹⁴ Unlike *Carle Foundation*, in *Hope School* it was conceded that the activity was not related to the tax-exempt purposes of the organization.¹¹⁵ The issue, however, was whether the activity was a regularly conducted trade or business.¹¹⁶

The Hope School,¹¹⁷ after unsuccessfully attempting to solicit contributions, engaged a private company to send out packages of greeting cards to prospective contributors, who were allowed to keep the cards

111. For 1971 and 1972, the years under consideration, pharmaceutical sales other than from the exempt hospital and its patients were over \$800,000, resulting in almost \$150,000 of income. 611 F.2d at 1198.

Treas. Reg. § 1.513-1(d)(3) provides in pertinent part:

Where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business.

Treas. Reg. § 1.513-1(b), setting forth guidelines for what is an unrelated trade or business, provides in pertinent part:

Activities or producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, *the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes.*

(Emphasis added).

112. 2 C.B. 245 (1968).

113. 611 F.2d at 1199.

114. *Hope School v. United States*, No. 79-1239 (S.D. Ill. Jan. 2, 1980).

115. See 612 F.2d at 301.

116. See text accompanying note 101 *supra*. In *Carle Foundation*, it was conceded that the pharmacy conducted a trade or business. 611 F.2d at 1194.

117. Hereinafter referred to as the School.

at no charge. If no contribution was received, the greeting card company bore the economic loss. The greeting card company kept the first \$1.10 per package received from contributors and the balance was retained by the School.¹¹⁸ In assessing the tax on unrelated business taxable income, the Internal Revenue Service characterized the first \$2.00 (or less) received per box as income and any amount in excess of \$2.00 as a donation.¹¹⁹

In finding that the activity was not a regularly conducted trade or business, the Seventh Circuit noted that the Internal Revenue Code does not contain a definition of "trade or business" but that Treasury Regulations and case law provide guidance.¹²⁰ The Seventh Circuit then based its decision upon an application of the facts to a Treasury Regulation which provides, in part:

On the other hand, where an activity does not possess the characteristics of a trade or business . . . such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations.¹²¹

In the opinion of the Seventh Circuit, the solicitation activity did not present an unfair competitive advantage and the greeting cards qualified as low cost articles incidental to the solicitation of charitable contributions.¹²²

Hope School offers little guidance as to when the "low cost articles" exception is applicable. As the Seventh Circuit noted, "[n]o hard and fast rule can be formulated to determine whether an activity falls within the 'low cost articles' exception; rather, the facts must be viewed as a whole, keeping in mind the congressional concern with unfair competition."¹²³

Carle Foundation, on the other hand, may provide somewhat more guidance for application of the tax on unrelated business taxable income to pharmaceutical sales by hospital pharmacies similarly situated. Inasmuch as the key factor in such cases is undoubtedly whether the activity is in direct competition with sales by non-exempt businesses, the size and extent of pharmaceutical sales activities to customers other than hospital patients will be of great importance in resolving the issue.

118. 612 F.2d at 300.

119. *Id.* at 301.

120. *Id.*

121. Treas. Reg. § 1.513-1(b) (1980).

122. 612 F.2d at 304.

123. *Id.*

TRUSTEE DISCRETION RESULTS IN PRIVATE FOUNDATION STATUS

The Seventh Circuit was called upon to decide a different issue relating to tax-exempt organizations in *Quarrie Charitable Fund v. Commissioner*.¹²⁴ In affirming the Tax Court,¹²⁵ the Seventh Circuit decided that the discretion of the trustee of the Quarrie Fund¹²⁶ to substitute beneficiaries caused the Fund to be classified as a private foundation.

In an attempt to preclude tax abuse of family private foundations,¹²⁷ the Tax Reform Act of 1969¹²⁸ imposed substantial burdens¹²⁹ on tax-exempt organizations which are categorized as private foundations.¹³⁰ Excepted from the definition of a private foundation are certain types of public charities.¹³¹ Similarly, supporting organizations of public charities, defined as organizations which "[are] organized, and at all times thereafter [are] operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of *one or more specified organizations described in paragraph (1) or (2) . . .*"¹³² are excepted from private foundation status.¹³³ The Fund claimed to be such a supporting organization.

The trustee of the Fund, a bank, was required by the trust agreement to distribute Fund income to certain designated public charities. The trustee, however, was granted the discretion to select other "charitable, scientific, educational or religious corporations, trusts, funds or foundations" as beneficiaries in the event the stated charitable purposes became "unnecessary, undesirable, impracticable, impossible, or no longer adapted to the needs of the public"¹³⁴

According to Treasury Regulations, supporting organizations may substitute a "publicly supported organization which is designed by

124. 603 F.2d 1274 (7th Cir. 1979).

125. *Quarrie Charitable Fund v. Commissioner*, 70 T.C. 182 (1978).

126. Hereinafter referred to as the Fund.

127. Donations to tax-exempt private foundations are, with certain limitations, deductible as charitable contributions. I.R.C. § 170.

128. Pub. L. No. 91-172, 83 Stat. 487 (1969).

129. See I.R.C. §§ 4940-4945.

130. A private foundation is defined as any organization described in Code section 501(c)(3) other than certain enumerated categories. I.R.C. § 509(a). For the definition of a section 501(c)(3) organization, see note 98 *supra*.

131. I.R.C. § 509(a). Public charities were excepted inasmuch as exposure to public scrutiny and dependence upon public support were considered sufficient to prevent abuse. See 603 F.2d at 1277.

132. I.R.C. § 509(a)(3) (emphasis added). The "specified organizations described in paragraph (1) or (2)" are generally public charities.

133. I.R.C. § 509(a)(3).

134. 603 F.2d at 1277.

class or purpose, rather than by name" for a designated organization "but only if such substitution is conditioned upon the occurrence of an event which is beyond the control of the supporting organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the publicly supported organization or organizations designated in the articles" ¹³⁵ The Seventh Circuit held that the trustee's discretion in *Quarrie Charitable Fund* exceeded the objective standards set forth in the regulations for allowing a substitution of beneficiaries. In the court's analysis, granting the trustee the subjective power to substitute beneficiaries when the designated charitable use becomes "undesirable" did not create an objective standard which the regulations would require. ¹³⁶

Quarrie Charitable Fund illustrates the close scrutiny courts will give to the powers of a trustee so as to accomplish the legislative intent behind the Tax Reform Act of 1969 ¹³⁷ in preventing tax abuse of private foundations. The use of private foundations has been sharply curtailed as a result of the changes brought about by the Act. ¹³⁸

Where trusts were established prior to the enactment of the Tax Reform Act of 1969, trustees may have felt unable to prevent the trust from being deemed a private foundation. In Illinois, however, a trustee is granted the power to amend the terms of the governing instrument to preclude private foundation status. ¹³⁹ As noted by the Seventh Circuit, the trustee in *Quarrie Charitable Fund* was aware of this option and did not pursue it. ¹⁴⁰ The Seventh Circuit stated that the trustee who was aware of this right and chose to ignore it attempted to retain more authority than the statute and regulations would appear to allow. ¹⁴¹ One can only speculate as to whether a different result would have been reached if this option did not exist.

The holding in *Quarrie Charitable Fund* may cause banks and other trustees to examine the discretion granted for substitution of beneficiaries. Where that discretion exceeds the permitted powers outlined in Treasury Regulations, that discretion should be limited so as to preclude classification as a private foundation.

135. Treas. Reg. § 1.509(a)-4(d)(4)(i)(a) (1980).

136. 603 F.2d at 1279.

137. See General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., Pub. Law 91-172, prepared by the Staff of Joint Committee on Internal Revenue Taxation 30 (Dec. 3, 1970).

138. See Worthy, *The Tax Reform Act of 1969: Consequences for Private Foundations*, 39 L. & CONTEMP. PROB., Autumn, 1975, at 232.

139. ILL. REV. STAT. ch. 148, § 51 (1979).

140. 603 F.2d at 1280-81.

141. *Id.* at 1281.

APPLICATION OF THE TAX BENEFIT RULE

Simply stated, under the tax benefit rule, if an amount deducted from gross income is recovered in a later year, the recovery constitutes income in the year of recovery.¹⁴² Although the tax benefit rule, which has been established through judicial precedent,¹⁴³ is not a difficult concept, courts often have difficulty in its application.¹⁴⁴ This difficulty is illustrated by the Seventh Circuit decision in *Home Mutual Insurance Co. v. Commissioner*.¹⁴⁵ On the other hand, the Seventh Circuit easily applied the rule in *First Trust and Savings Bank of Taylorville v. Commissioner*,¹⁴⁶ which illustrates the type of situation to which the tax benefit rule is meant to be applied. Due to the rather limited application of the facts of these cases, their value in structuring future transactions is also limited. They are discussed here to reflect the approach of the Seventh Circuit in handling such cases.

The facts in *First Trust and Savings Bank of Taylorville* were not complicated. Shareholders of incorporated banks located in Illinois were subject to personal property tax on the value of their shares.¹⁴⁷ Banks customarily paid the tax on behalf of their shareholders.¹⁴⁸ Although the tax on personal property owned by individuals was abolished effective January 2, 1971, by an amendment to the Illinois constitution,¹⁴⁹ a suit was filed questioning the validity of that amendment.¹⁵⁰ Pending the outcome of the litigation, the Illinois legislature required taxes to be deposited in an escrow account.¹⁵¹

In 1972, the taxpayer bank paid the amount of personal property tax on the value of its stock to the escrowee and deducted this amount in calculating its taxable income. In 1973, the constitutional amend-

142. See, e.g., *Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. of Indianapolis v. Commissioner*, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967).

143. It has also been codified as to certain situations. See I.R.C. § 111.

144. Compare *Tennessee-Carolina Transp., Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979) with *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963).

145. Nos. 79-1602, 79-1603 (7th Cir. April 29, 1980).

146. 614 F.2d 1142 (7th Cir. 1980).

147. See ILL. REV. STAT. ch. 120, § 557 (1979) (This provision has been repealed, effective Dec. 31, 1982, by Pub. Act 81-1, 1st Special Sess. § 11).

148. This procedure was followed to satisfy a statutory requirement that banks retain sufficient dividends to pay all personal property taxes assessable against their shares. See ILL. REV. STAT. ch. 120, § 558 (1979).

149. ILL. CONST. art. IX- § 5(c).

150. See note 148 *supra*.

151. ILL. REV. STAT. ch. 120, § 676.01 (1979). (This provision has been repealed, effective Dec. 31, 1982, by Pub. Act 81-1, 1st Special Sess. § 11).

ment was held to be valid¹⁵² and the taxes were refunded. The checks were payable to the taxpayer and its shareholders jointly, and the taxpayer endorsed the checks and forwarded them to its shareholders.¹⁵³

The Seventh Circuit, affirming the district court,¹⁵⁴ held that the refund constituted income to the taxpayer under the tax benefit rule. The taxpayer had contended that the refunded taxes should constitute taxable income to the shareholders on whose behalf it originally paid the taxes. Inasmuch as it was already obligated to endorse the refund checks to its shareholders, the taxpayer took the position that it had not "recovered" the taxes within the meaning of the tax benefit rule.¹⁵⁵ The court, however, held that the taxpayer had, in fact, "recovered" these amounts. The Seventh Circuit stated that the disposition of the proceeds by the taxpayer did not determine whether there had been a "recovery."¹⁵⁶

As the court concluded, "[t]o allow the Bank a deduction for personal property taxes paid without subjecting it to income tax when its payment is refunded is to produce precisely the sort of windfall which the tax benefit rule is designed to preclude."¹⁵⁷ This view was predicated on the premise that an event which is inconsistent with a prior deduction may require application of the tax benefit rule.¹⁵⁸

It is interesting to note that, unlike the analysis in *Falkoff v. Commissioner*,¹⁵⁹ the Seventh Circuit here correctly analyzed the tax implications of its decision. The taxpayer argued that there would be no loss of revenue to the government in that the shareholders were taxable on the distribution from the taxpayer. The court correctly analyzed that the distribution from the taxpayer constituted non-deductible corporate dividends which were taxable to the shareholders. Therefore, there would, in fact, have been a loss of revenue if the taxpayer's position had been sustained.¹⁶⁰

In *Home Mutual Insurance Co.*, the Seventh Circuit, affirming in

152. *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973).

153. 614 F.2d at 1144.

154. *First Trust & Sav. Bank of Taylorville v. Commissioner*, No. 77-3110 (C.D. Ill. May 3, 1979).

155. 614 F.2d at 1145. In *Lincoln Nat'l Bank v. Cullerton*, 18 Ill. App. 3d 953, 958-59, 310 N.E.2d 845, 849 (1974), it was held that any personal property taxes which were refunded belonged to the shareholders regardless of who had actually paid them.

156. 614 F.2d at 1146.

157. *Id.*

158. *Id.*

159. See text accompanying notes 36-39 *supra*.

160. 614 F.2d at 1146-47.

part and reversing and remanding in part the Tax Court,¹⁶¹ found the tax benefit rule to be inapplicable.¹⁶² Judge Pell, in his dissenting opinion, on the other hand, felt that the case presented a classic example of a situation in which the tax benefit rule should be applied.¹⁶³

The issue in *Home Mutual Insurance Co.* arose as a result of a change in the method of taxing mutual fire and casualty insurance companies. Commencing in 1963, underwriting income of such companies became subject to tax.¹⁶⁴ In calculating underwriting income, there is allowed a deduction for losses incurred in the taxable year, which includes actual losses paid plus any increase or minus any decrease in unpaid losses outstanding during the year (as well as other adjustments not relevant to the issue in this case).¹⁶⁵ The unpaid losses outstanding account, a reserve for unsettled claims, is increased by the estimated loss at the time a claim is made and is decreased by such estimated amount at the time the claim is settled.¹⁶⁶

At the time the method of taxation was changed, the taxpayer, a mutual casualty insurance company, established an estimated losses outstanding account for claims unsettled at December 31, 1962.¹⁶⁷ When actual experience proved this estimate to be too high, the taxpayer claimed that the estimated losses outstanding account should be adjusted downward to reflect the amount of actual losses.¹⁶⁸ The effect of overstating the estimated losses outstanding was to reduce the amount of the losses incurred deduction, thereby increasing underwrit-

161. *Home Mut. Ins. Co. v. Commissioner*, 70 T.C. 944 (1978).

162. The Seventh Circuit affirmed the Tax Court holding that a special transitory underwriting loss allowed by I.R.C. § 821(c) is to be deducted from underwriting gain less the protection-against-loss deduction rather than from total underwriting gain. Nos. 79-1602, 79-1603, slip op. at 20-21 (7th Cir. April 29, 1980). This issue is unrelated to the application of the tax benefit rule and will not be discussed in this article.

In finding the tax benefit rule to be inapplicable, the Seventh Circuit reversed the Tax Court and denied the adjustment claimed by the taxpayer. See text accompanying notes 164-178 *infra*.

Following the decision by the three-judge panel, the case was reargued en banc. The full court issued a subsequent opinion also finding against the taxpayer for the reasons stated in the majority opinion of the three-judge panel. However, Judges Fairchild, Pell and Bauer dissented. Nos. 79-1602, 79-1603 (7th Cir. Dec. 23, 1980).

The taxpayers had argued, in the alternative, that the tax benefit rule would allow the taxpayer to exclude cash salvage subrogation recoveries made on pre-1963 claims from computation of the losses incurred deduction. This issue had not been decided by the Tax Court due to its finding in favor of the taxpayer on other grounds. The case was therefore remanded to the Tax Court for determination of this issue.

163. *Id.* at 26-27.

164. See I.R.C. §§ 821-826.

165. I.R.C. § 832(b)(5); Treas. Reg. § 1.832-4(c) (1980).

166. I.R.C. § 832.

167. Nos. 79-1602, 79-1603, slip op. at 4 (7th Cir. April 29, 1980).

168. The losses outstanding account was overestimated by \$402,314, which was 14.74% of the original December 31, 1962 estimate of \$2,729,746. *Id.*

ing income, for the year in which the claim was settled.¹⁶⁹

The Tax Court appears to have found in favor of the taxpayer under the tax benefit rule although characterizing its decision as based upon something other than the tax benefit rule. The December 31, 1962, unpaid losses outstanding, in the opinion of the Tax Court, did not result in a tax benefit in that underwriting income was not subject to tax before 1963 and, as the court observed, "[w]e know of no case which holds that the absence of a tax benefit in the prior year gives rise to a [tax] deduction in the current year."¹⁷⁰ The court concluded that "although we have not identified our theory as the tax benefit rule, when a casualty insurance company releases its excessive reserves, it constitutes taxable income only to the extent that the amount released consists of amounts previously deducted."¹⁷¹

The Tax Court decision was based, in part, on a determination that the adjustment was analogous to a permitted retroactive adjustment of inventory and also to a permitted adjustment of loss reserves of a savings and loan association.¹⁷² The Seventh Circuit distinguished both of these analogies and instead analogized the facts presented to two life insurance tax cases in which it was held that the taxpayers could not reduce beginning reserves to reflect actual experience where the statutory language and legislative history precluded such an adjustment.¹⁷³ In each instance the reserve was estimated on the basis of information known at that time.¹⁷⁴ An adjustment based upon a mathematical error apparently would have been acceptable.¹⁷⁵

The Seventh Circuit also concluded that the tax benefit rule was inapplicable.¹⁷⁶ The taxpayer had argued that the exclusionary aspect of the tax benefit rule allowed the adjustment to be made. Under the exclusionary aspect of the tax benefit rule, recovery of an item is excluded from income if it did not previously result in a tax benefit.¹⁷⁷ In the opinion of the court, however, the exclusionary aspect of the tax benefit rule cannot be applied unless the inclusionary aspect (i.e. inclu-

169. Nos. 79-1602, 79-1603, slip op. at 5 (7th Cir. April 29, 1980). For an illustration of the tax effect of an overestimate see 70 T.C. 944, 947.

170. 70 T.C. at 953.

171. *Id.*

172. *Id.* at 950-51.

173. *Lutheran Mut. Life Ins. Co. v. United States*, 602 F.2d 328 (Ct. Cl. 1979), *cert. denied*, 100 S. Ct. 2154 (1980); *Pacific Mut. Life Ins. Co. v. Commissioner*, 48 T.C. 118 (1967), *rev'd on other grounds*, 413 F.2d 55 (9th Cir. 1969).

174. See Nos. 79-1602, 79-1603, slip op. at 13 (7th Cir. April 29, 1980).

175. See *id.* at 9.

176. *Id.* at 14.

177. *Id.* at 14-15.

sion in income of the recovery of an item previously deducted) would result in the inclusion of recoveries which, pursuant to the statute, are not income.¹⁷⁸ Because recoveries of overestimated liabilities are subject to tax as a result of the statutory language rather than application of the tax benefit rule, the majority concluded that the case did not fall within the scope of the tax benefit rule.

Judge Pell, on the other hand, in a less complicated dissenting opinion, simply concluded "inasmuch as the taxpayer realized no real economic gain from its payment of the claims made against its policies, and it received no tax benefit from the excess accruals for unpaid losses made prior to 1963, it should not be subjected to tax on its subsequent recovery of these excess accruals. This is the essence of the long standing 'tax benefit rule!'"¹⁷⁹

Aside from illustrating the difficulty courts have in applying the tax benefit rule, *Home Mutual Insurance Co.* is important to consider when establishing reserves in the event of a change in the method of taxation. The subsequent tax effect of either an overestimate or an underestimate of a reserve account should be considered so as to minimize the amount of federal tax liability.

CONCLUSION

A review of the tax cases decided by the Seventh Circuit is useful not only for planning transactions involving the relatively few issues and unique fact patterns present in those cases, but it is also helpful for planning other transactions by providing insight as to the approach of the court in deciding tax cases. For example, both *Sgro* and *Ransburg* illustrate the approach of the court to interpret strictly the language of the Code. In relying upon a specific Code provision to support a position, all statutory requirements should be satisfied.

Where the resolution of an issue is dependent upon the application of a unique fact pattern, the court may analyze the legislative intent in enacting a particular statute or the reason for establishing a principle by judicial precedent. This is evident from the decisions in *Carle Foundation* and *Hope School*, where the Seventh Circuit analyzed the application of the tax on unrelated business income in terms of whether the

178. *Id.* The Seventh Circuit distinguished one case, *American Financial Corp. v. Commissioner*, 72 T.C. 506 (1979), in which the exclusionary aspect of the tax benefit rule was applied to the treatment of salvage and reinsurance recoverable under I.R.C. § 832(b)(5), although there was no assurance that recoveries would be taxed. The deduction in *American Financial Corp.* had not resulted in a tax benefit due to certain net operating losses. *Id.* at 18-19.

179. *Id.* at 26-27.

tax-exempt organizations had a competitive advantage over taxable entities engaged in similar activities. The tax was enacted to preclude such a competitive advantage and the legislative intent is set forth in Treasury Regulations. Similarly, the court in *Quarrie Charitable Fund* analyzed the fact pattern in terms of the abuses the private foundation legislation was intended to prevent. Although the decision in *Sgro* was based upon a technical analysis of the statutory language, the court did note the legislative intent in enacting the federal tax lien priority statute. As these cases illustrate, it may be helpful to be familiar with the legislative history of a particular statute in structuring a transaction which is subject to varying interpretations. *First Trust and Savings Bank of Taylorville* and *Home Mutual Insurance Co.* evidence the need for understanding the reason for the court-established tax benefit rule.

The most interesting cases decided by the Seventh Circuit during the period June 1, 1979 to May 31, 1980, were *Falkoff* and *Foglesong*. *Falkoff* reflects the willingness of the court to approve creative tax planning arrangements which can be supported as having some valid business purpose other than tax avoidance. *Foglesong* has the most potentially far-reaching application. Although the court did not decide the section 482 issue, the language of both the majority and dissenting opinions indicates that the result may have been different if it had been called upon to decide that issue.

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